In the

United States Court of Appeals

For the Ninth Circuit

ROBERT F. ELLISON and
Cleo A. (Ellison) Walker, *Appellants,*

v.

WILLIAM E. FRANK, United States District Director of Bureau of Internal Revenue for the State of Washington and the Territory of Alaska, *Appellee.*

NO. 15318

APPELLANTS' BRIEF

Appeal from the United States District Court for the Western District of Washington, Southern Division.

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STATEMENT OF JURISDICTION

This is an appeal from a final judgment entered by the United States District Court for the District of Washington, Southern Division. Appellants brought suit for refund of claimed overpayment of federal individual income taxes for the year 1949 paid to appellee (R.3). The United States District Court for the Western District of Washington, Southern Division, had jurisdic-

tion under 28 U.S.C. Sec. 1340 (R.25). The defendant appeared and defended the action on the merits (R.6).

The United States District Court entered final judgment adverse to appellants (R.25), who gave timely notice of appeal (R.26).

The United States Court of Appeals for the Ninth Circuit has jurisdiction to review the judgment under provisions of 28 U.S.C. Sec. 1291.

STATEMENT OF THE CASE

This controversy relates to the recovery of individual income taxes for the calendar year 1949. The amount in controversy, $11,361.10, represents the difference between federal income taxes at normal rates upon the sum of $50,380.06 and the amount of tax upon that sum at the rate applicable to capital gains.

During the year 1947, Northwest Door Company, hereinafter called Northwest, in accordance with a prior agreement with Robert F. Ellison, executed a timber purchase contract with the Department of Agriculture, Forest Service. (R.45 Ex. 2). This contract was not formally assigned to Ellison by Northwest. During the year 1949 Ellison removed a portion of the timber and elected to report a part of the profit thereon, $50,380.06, as capital gains under

the provisions of Sec. 117 (k), I.R.C. 1939. The income tax return of Robert F. Ellison was filed jointly with his wife, Cleo A. (Ellison) Walker, and the tax paid thereon for the year 1949 included taxes upon $50,-380.06 at the rate applicable to capital gains. This return was filed with, and the payments of income tax were made to, the Collector of Internal Revenue, Tacoma, Washington.

Upon audit of Ellison's return, the Commissioner of Internal Revenue determined that Ellison was not entitled to the benefits of Sec. 117 (k), I.R.C. 1939 upon timber removed by him and assessed a deficiency of $11,839.10, of which $11,361.10 represented the tax at ordinary rates upon the profits on timber reported by Ellison as subject to capital gains.

Appellants filed claim for refund of the tax paid to appellee and upon failure of the appellee to act thereon brought suit for refund. At trial was adduced a written instrument to which Ellison and Northwest were parties; this instrument stated that Ellison had no right, title or interest in the timber or the logs to be obtained therefrom. (R.43, 127 Exhibit 3). Other evidence was that prior to bidding on the timber Northwest had agreed to loan Ellison what he needed to acquire and log the timber and that the contract between the Department of Agriculture and Northwest

was retained in Northwest's name to secure loans to Ellison and to secure its compensation for making the loans to Ellison, i.e., Ellison's agreement to sell the logs to Northwest; which agreement Ellison carried out.

The court held that in the years 1947 through 1949, Ellison was self employed and was exclusively engaged as a sole proprietor in the business of producing, transporting, and marketing logs and other raw products of the forest in Southwestern Washington (R.25).

For review are the trial court's findings of fact that:

1. Ellison had no right, title or interest in the timber at any time. He was to perform the service of logging the timber for Northwest Door Company and was to be paid for his services only. The payment was to be measured by the market value of the logs. Title to the timber lay at all pertinent times only in the United States and in Northwest Door Company, but not in Ellison. (R.23-24).

2. The present taxpayers (Ellision) did not at any time own or have a contract right to cut the Green Forks timber, nor did they cut said timber for use in their own business or for resale. The Commissioner correctly determined that the gain from Ellison's logging operations was taxable to the taxpayers as or-

dinary income. Taxpayers did not overpay any tax and are entitled to no recovery. (R.25).

QUESTIONS PRESENTED

1. Does not the evidence require a finding that Ellison was the equitable owner of the timber?

2. Does the phrase contained in Sec. 117 (k) (1) "by the taxpayer who owns or has a contract right to cut such timber" entitle the equitable owner of the contract to the benefits of this section, or does the phrase restrict the benefits of the statute to the individual who has both legal and equitable title?

3. Is a taxpayer precluded from showing that a written instrument between himself and a third party does not in fact reflect the entire agreement between the parties, where the parties are in agreement it does not and the parties' performance bears this out?

SPECIFICATIONS OF ERROR

1. The District Court erred in holding that Exhibit 2, the contract between Northwest Door Company and the Department of Agriculture, and Exhibit 3, the contract between Ellison and Northwest Door Company, were self limiting and represented the entire transaction between the parties; and that the transactions

actually consummated between these parties could not be shown by other evidence.

2. The District Court erred in finding that Ellison did not own equitable title to the logs he harvested and that Ellison had no proprietary interest in the timber, and that the logs removed from the Green Forks tract were not cut and sold in the course of Ellison's trade or business.

SUMMARY OF ARGUMENT

I

During the year 1947, the Northwest Door Company entered into an agreement for the purchase of timber on a "pay as cut basis" from the Department of Agriculture, Forest Service. The uncontradicted testimony in this case is that the purchase was made by Northwest at the behest and for the benefit of Robert F. Ellison and that the contract was assigned by Northwest to Ellison with Northwest remaining a party thereto as guarantor although formal assignment was not recorded upon the records of the Forest Service. The evidence and testimony also establishes that both the Forest Service and Northwest treated and dealt with Ellison in all matters of substance relating to the contract as the assignee and beneficial owner of the contract right to cut and remove the timber.

To provide security for Northwest's loans and its right to first refusal of logs from the tract, Northwest and Ellison entered into an agreement providing that title and interest in the timber and logs belonged solely to Northwest. The uncontradicted testimony and the evidence in this case was that the agreement was intended and used as a security device only and that Northwest and the Forest Service dealt with Ellison in all matters of substance relating to the timber and the logs as the owner and the real party in interest.

II

In determining the property rights of Ellison in the timber contract and the logs obtained from the tract, the Court based its findings and conclusions solely upon the written agreement for security without giving weight to other evidence and the testimony of the witnesses in the case as though the written agreement represented the entire transaction. The undisputed facts in this case establish that the agreement was written solely for security purposes and that Ellison was the equitable, beneficial owner of the contract right to cut the timber and of the logs obtained therefrom. It was error for the Court to define the rights of Ellison solely upon the written agreement without consideration of extrinsic evidence explanatory of its

purpose and the relation of the contract to the whole transaction.

The restriction placed upon itself by the Court prevented the Court's following the well established rule that in tax matters substance prevails over form. The restriction also prevented the Court's following the law of the State of Washington in determining the character of the contract between Northwest Door Company and Robert F. Ellison and the rights of the parties, with the result that those findings of the Court relating to the property rights of Robert F. Ellison in the contract for cutting and purchase of the timber and the logs obtained therefrom are clearly erroneous.

III

Because the Court restricted its conclusions to the rights of the parties as determined by it from the written agreement between Northwest and Ellison, the Court was unable to consider the differences between the instant case and that of *Helga Carlen* decided in this Court. 220 F.2d 338 (1955).

The basic distinction is that in the instant case, there was uncontradicted testimony from the President of Northwest and its counsel that the purpose of the contract was solely for security of loans to be made in

the amount of $100,000.00, and all of the evidence corroborates this testimony. In the *Carlen* case, the contract reserving title accurately reflected the status of the parties.

The uncontroverted testimony in this case is that the timber was purchased at the behest and for the benefit of Ellison who was treated by all parties as the real party in interest and the owner of the contract to cut the timber and of the logs therefrom; in the *Carlen* case, the timber was purchased before the logging partnership was even formed.

In the instant case, Northwest did not buy the logs from Ellison until a consumer had been found; in the *Carlen* case, partnership was paid when the logs were dumped.

In the instant case, Ellison had complete discretion in regard to performance of the contract subject of course to the terms of the agreement with the Forest Service; in *Carlen*, the partnership agreed to work not less than forty-eight hours per week.

The Court found as a fact that Ellison was exclusively engaged as a sole proprietor in the business of producing, transporting, and marketing logs and other raw products of the forest. The Tax Court did not so find in the *Carlen* case.

The Court's failure to consider relevant evidence prevented a finding that the Forest Service contract had been assigned to Ellison and that he was the owner of the contract right to cut the timber and possessed equitable title to the timber on the Green Forks tract and to the logs obtained therefrom. As a result of this error, the Court found that Ellison owned no proprietary interest in the timber cutting contract, the timber, or the logs obtained therefrom, and that Ellison was not entitled to the benefits of Section 117 (k) I.R.C. (1939).

The judgment should be reversed for the Court's failure to consider all of the evidence in this case.

ARGUMENT

I

All evidence was that Northwest held the Forest Service contract for Ellison's benefit as security for loans and to secure its compensation for making the loans, i.e., Ellison's agreement to sell the logs to Northwest.

SUMMARY OF EVIDENCE

Robert F. Ellison and Cleo A. (Ellison) Walker, appellants here (plaintiffs below) were during the year 1949 husband and wife residing at Woodland, Wash-

ington. The appellants filed joint federal income tax returns for the year 1949 with the Collector of Internal Revenue, Tacoma, Washington. Cleo A. (Ellison) Walker, one of the appellants herein, appears solely by reason of the filing of a joint return (R.12).

During the calendar years 1947 through 1949 inclusive, the appellant, Robert F. Ellison, was self employed and was exclusively engaged as a sole proprietor in the business of producing, transporting, and marketing logs and other raw products of the forest (R.25). He was a logger, a man who goes into the woods, acquires timber, builds his own roads, and puts the logs into the market and sells them (R.87).

Northwest was a Washington corporation (R.13), engaged in the business of manufacturing fir plywood and fir doors. Northwest's plant utilized a grade of logs termed "peelers" (R.37).

During the years 1947 through 1949, Northwest acquired the logs required for plywood manufacture from two sources; purchases upon the open market and through the financing of the purchase of timber by loggers who agreed to sell the logs to be obtained from the tract to Northwest (R.37, 73).

In those instances where Northwest assisted the logger to obtain timber, it was customary for North-

west to secure its advances and other interests by means of a written contract or agreement. The precise nature of the security device to be used was left to the company's counsel after conferences with the President of Northwest, and was determined by the financial stability of the logger (R.38, 55, 56, 57, 61).

Theodore Franklin Wall, was employed January 1, 1947, by Northwest as the manager of a log storage and booming grounds (previously owned and operated by himself) near Woodland, Washington (R.80).

During the year 1946 (prior to his employment by Northwest), Wall had been requested by the United States Department of Agriculture, Forest Service, to look at a tract of timber on Green Forks Creek. This tract is hereinafter referred to as Green Forks. The timber was to be offered by the Forest Service at public sale (R.82). Shortly after this, Wall discussed this tract with Ellison who was looking for a logging operation (R.82, 85).

Wall had been instructed by Northwest to look for timber. He was aware that Ellison was looking for a logging operation; therefore Wall and Ellison looked over the Green Forks tract together at different times to see whether the timber could be taken out profitably. Both agreed that Ellison would require some one to finance the purchase (R.82, 83).

Prior to the time the Green Forks Tract was offered for sale, Ellison laid out road lines through the Tract and discussed with Wall the cost of removing the timber and the funds required by Ellison to finance the operation. Both agreed that from $75,000 to $100,000 would be required. Wall and Ellison also discussed the maximum sum Ellison would pay for the timber, which information Wall transmitted to Northwest (R.84, 85, 107), and to Northwest's Counsel with whom he discussed the amount of funds required by Ellison for the purchase and logging of the timber and Ellison's security for the proposed financing (R.52).

It was eventually decided after conferences between the President of Northwest and the Secretary of the corporation and its counsel, Edgar N. Eisenhower, that the purchase of the Green Forks Tract for Ellison would be financed by Northwest (R.48, 49, 56). In accordance with that decision, Northwest bid in the Green Forks timber at the Forest Service sale (R.45), with the intention of having Ellison perform the Forest Service contract and sell the logs to Northwest (R.52, 95). The contract between the Forest Service and Northwest for purchase of timber in the Green Forks Tract is dated September 8, 1947, and is identified as Exhibit 2 (R.45).

Eisenhower had been instructed to secure Northwest for advances to be made to Ellison and for the delivery of logs by Ellison from the Green Forks Tract, which Northwest desired to use in its plywood plant (R.52, 53). After considering all possibilities for security, including a loan on Ellison's equipment (R.61), Eisenhower adopted the security device which is Exhibit 3 (R.43) as "The best kind of security that I could get for my client" (R.58). Under this contract, executed in December, 1947, * Ellison borrowed $100,000.00 from Northwest in 1948 (R.70, 110).

In his dealings with the Forest Service and with Northwest Door, Ellison at all times treated the timber as his own (R.112).

In addition to paying Northwest the sums to be transmitted by Northwest to the Forest Service for stumpage on timber removed by him, Ellison also reimbursed Northwest for the cost of the timber cutting bond furnished to the Forest Service in connection with the Green Forks contract (Ex. 9, R.68, 70, 78-79). In all practical matters relating to performance of the contract including the provisions for cleanup and slash disposal, settlement of the problem with the Forest

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* Another Washington Corporation, Vancouver Plywood Corporation was brought into the transaction at the last minute. (R.13, 56). It was stipulated (R.65-66) that before any harvesting of timber took place, Vancouver Plywood Corporation withdrew from the deal.

Service was conducted by Ellison alone (R.94). Ellison dealt directly with the Forest Service without consulting Northwest in regard to making changes in the road adopted by the Forest Service. He also arranged an exchange of timber owned by the Forest Service for timber included in the original contract without requesting or obtaining prior approval from Northwest (R.101, 108-109, 110-111).

Northwest also treated the timber as the property of Ellison and charged the logs purchased from him to their log purchase account after deducting a cash discount for prompt payment (R.70, 76, 78), as distinguished from the accounts maintained with contractors who performed services for a fixed fee from whom no discount was claimed (R.70, 77, 78). Northwest paid Ellison the market price for the logs (R.130). Reinsch, Northwest's manager of log procurement testified that the risk of any loss of the logs before delivery was on Ellison (R.91). Northwest claimed no gain or loss on the Green Forks transaction (R.68-69), and as previously set forth, collected the cost of the indemnity bond from Ellison (R.70), as would a guarantor of Ellison's contract with the Forest Service. The transaction with Ellison was handled by Northwest in the same manner as other deals in which Northwest financed loggers (R.76).

Finally, over the objection of the District Director (R.64-67), there was admitted an inter-office memorandum (Ex. 7), between two officers of Northwest regarding the Green Forks deal, in which the following language was suggested for a proposed letter to Vancouver Plywood Corporation (R.135):

> "As you know, on the Green Forks timber neither of us will make any gain or loss on the logs, as the contract has been turned over to Ellison. All we will receive are logs at current market prices."

Effect of Evidence as showing Equitable Title in Ellison

Although the naked legal title to the timber passed directly from the Forest Service to Northwest, and was never in Ellison, all parties—the Forest Service, Northwest, and Ellison himself—treated Ellison throughout as the owner of the contract. As a matter of bookkeeping on Northwest's books, practical day to day dealing with the Forest Service, and economic interest in the value of the timber, this is precisely what he was. Northwest did not have to pay the Forest Service for the logs until they were scaled on delivery to Northwest (R.75-76). Until that point, all risk of loss was on Ellison (R.91). All risk of market fluctuation was also on Ellison until that point, and the court so found (R.24). Northwest had no interest in the transaction

except the obtaining of a supply of logs at market prices and recouping its advances. The real equity in the timber, in the sense of control, economic risk, and beneficial interest, was in Ellison. He dealt directly with the Forest Service, without the intervention of Northwest, not only in regard to the operating details of the operation (R.91-92), but also negotiated with the Forest Service a substitution of a tract of timber which was not included in their contract with Northwest for one that was (R.101, 110). Both the President of Northwest and its then counsel testified without contradiction that security was the only purpose for which title was retained (R.38-39, 52, 58, 61).

The foregoing testimony on this subject came entirely from officers and agents of Northwest, with no interest in the outcome of this litigation and was corroborated by Ellison. None of it was contradicted, and it was entirely consistent with the documents and other circumstances of the case.

In fairness to this Court, it should be pointed out at this point that the District Court did not arrive at this conclusion. Its finding 9 (R.23) is as follows:

> "9. The foregoing contract (i.e., Exhibit 3) was drafted after a full exploration of the situation by all concerned, and reflected the intentions of the parties precisely. Its provisions are clear and unambiguous. If the contract be subject to parol con-

struction, then the evidence fully shows that the contract meant what it said."

It is perfectly true that Exhibit 3 was drafted after a full exploration of the situation, and that its provisions are clear and unambiguous. Equally clear and unambiguous, however, was the testimony of both Tenzler, the President of Northwest, and Eisenhower, its counsel, that the sole function of the contract was as a security device. When viewed in this context, it becomes apparent how the provisions of the contract can be clear and unambiguous and yet not, to use the court's phrase, mean what they say. Although the contract provides that all title to the logs remains in Northwest throughout (R.130), and that Ellison is to be paid for "services" (R.130), it must be accepted that the retention of title was solely for the purpose of security, or else the uncontradicted, unambiguous testimony of disinterested witnesses must be rejected as false. This evidence, moreover, was not inherently improbable, although in contradiction to the formal terms of a written instrument. It was completely consistent with the functions and purposes of that instrument, and served to explain its operation. Moreover, the practical construction of the instrument, adopted by all parties, shows that it was treated as a security device, and not as establishing the beneficial interest in the timber.

In this connection, it is of particular cogency as corroboration of the purpose of the document, that Northwest treated other logs sold by Ellison to Northwest in the manner that logs from the Green Forks Tract were treated, and that Northwest charged and deducted from Ellison only the exact amount required to pay the Forest Service for the timber and no more. Northwest did not buy the logs from Ellison until a consumer had been found, at which time it deducted a cash discount for payment within ten days of that date. (R.76). Ellison thus permitted Northwest to treat him as the beneficial owner, even when it was against his pecuniary interest to do so.

It is certainly not an unusual concept that title to property should be placed in a creditor for purposes of security, and that the debtor should retain the equitable ownership thereof. Cf. *L. D. Wilson*, 26 T.C. No. 56 (1956), wherein the Tax Court held that for purposes of Sec. 117 (k) (2), a partnership was the "owner" of timber which it had a right to cut, subject to reservation of title in the seller for security purposes. The court compared the situation of the partnership with a conditional vendee and with a mortgagor. In this connection, it is worth noting that Eisenhower testified that he considered using a chattel mortgage to accomplish the same purpose as the instrument he

finally adopted, but rejected it because the security was inadequate (R.61).

The Court's finding can be explained on the basis of two misconceptions: First, that the contract was not subject to parol construction, and second; that this case was substantially indistinguishable from the case of *Helga Carlen*, 20 T.C. 573 (1953); aff'd. *Carlen v. Commissioner*, 220 F.2d 338 (9th Cir. 1955). Both of these positions were urged by the district director (R.35, 43, 49), and both were ultimately adopted by the court (R.123-127).

Despite the fact that the court phrased his finding in the alternative (i.e. "If the contract be subject to parol construction . . ."), it seems clear that he was laboring under the misapprehension that he was bound by the designations that the parties adopted for themselves in the contract. His remarks (R.125) to the effect that the contract was not lightly entered into, and was drafted by a person who knew what he was doing demonstrates this. The fact that parties may, for security purposes, carefully draft an instrument in such a way that it gives certain rights in the event of default, however, does not necessarily mean that it accurately defines the interests of the parties for any and all purposes.

This finding and the following one, if taken literally, would require an underlying determination that both Tenzler and Eisenhower, the President and counsel of Northwest, deliberately testified falsely when they stated that the only rights retained by Northwest were for security purposes. Since they were both respectable, disinterested witnesses, whose testimony was unimpeached, it is difficult to believe that this is the conclusion at which the court actually arrived.

The Court will look in vain for any evidence in the record corroborating the trial judge's finding that the document means what it says, insofar as the relationship of Ellison and Northwest and their respective interests in the timber are concerned. The sole factor guiding the trial court in his decision was the instrument—viewed not in context, but in a vacuum.

In the case of *Landa v. Commissioner*, 206 F.2d 431, 432 (D.C. Cir. 1953), the Tax Court had made a statement in its opinion similar to the remarks of the trial judge in this record (R.123-124), saying:

> "Whether this evidence was properly admitted might be an interesting question to which, however, we are not now required to give an answer. In the light of the agreement itself, and the circumstances of its execution, we prefer to rely on the contents of a written document rather than to ascribe probative weight to oral testimony contradicting it."

The Court of Appeals, citing *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252, 60 S. Ct. 209, (1939), held this to be error, and pointed out, 206 F.2d 431, 432:

> "Moreover, the oral testimony here was not barred by the parol evidence rule, since the Commissioner 'was not a party or privy of a party to [the] written agreement [s?].' Nor was it 'inherently improbable in the light of the circumstances and the situation of the parties as disclosed by other evidence.' "

The case was therefore remanded to the Tax Court for consideration of the oral testimony. That court thereupon stated that it had weighed the testimony and rejected it on the ground that "written instruments were 'more trustworthy than the recollection of a witness giving contradictory oral testimony.' " In a divided opinion, the Court of Appeals held that the decision was clearly erroneous and determined that the taxpayer was entitled to the benefit of the facts relating to the substance of the transaction, despite the form it had taken. *Landa v. Commissioner*, 211 F.2d 46 (D.C. Cir. 1954).

A long list of cases holding that parol evidence is admissible as against a stranger to the contract is set forth in *Haverty Realty & Investment Co.*, 3 T.C. 161, 167 (1944), including three from this Circuit. This list, together with another case, were cited with approval

in the first *Landa* decision. It is eminently clear that both the district director and the court below were wrong in their insistence that the contract spoke for itself.

Parol evidence was not only admissible as between the parties to this litigation, but Washington law establishes that even between the parties to the instrument, evidence of the circumstances surrounding its execution is admissible in determining whether the intent of the parties to a document be that it is for security purposes. *Pittwood v. Spokane Savings & Loan Society*, 141 Wash. 229, 251 Pac. 283 (1926). It is, of course, almost axiomatic that the nature of the property interests to which the tax applies is determined by the rights of the parties under state law. *Ward v. Commissioner*, 224 F.2d 547, 551 (9th Cir. 1955).

The court did purport to consider the oral evidence, of course, both in his oral opinion from the bench (R.123-127) and his subsequently entered findings (R.23). That oral opinion shows that his conception of the effect of the contract made it impossible for him to give the testimony appropriate weight. Such language as "I can't see how we can possibly get away from the terms of this contract," (R.124), and "Under no conceivable situation under this contract did this timber

ever come under the ownership of Ellison" (R.124), as well as that portion of the opinion relating to the Court's interpretation of the contract (R.125-126), shows unmistakably that the Court did not consider the contract between Northwest and Ellison in relation to the entire transaction but restricted its determination of the property rights of Ellison to the written instrument alone without regard to the testimony or evidence of the witnesses in this case.

The Court's opinion, if it be not a determination that the written instrument and only that written instrument defined and determined the rights and interests of the parties is impossible of reconciliation with the Court's granting any weight or credibility to the testimony of the witnesses. The relationship of the instrument to the entire transaction and its purpose as a security device was fully explained by the uncontradicted testimony of the President and the Secretary of Northwest.

Tenzler, President of Northwest, stated:

> "Rights that we retained were to protect our interests, the money we may have advanced, and to see to it that there was a proper performance, [of the] contract on which the company may be involved and the right to purchase the logs from the logger at prevailing market prices or to have the first privilege of purchasing the logs at prevailing market prices." (R.38-39).

He testified that this policy was followed in the Green Forks transaction. (R.39,43).

Eisenhower also testified that the purpose of the contract was a security device; he stated:

> "I had instruction from our conference [27] to draft such instrument as I thought would safeguard Northwest Door in the advances which it was making to Mr. Ellison, and secondly, to see that Mr. Ellison delivered to Northwest Door the logs which Northwest Door wanted to use in its plywood plant. *Those were my instructions. And this was before the bid date. After the bid date I was told that Vancouver Plywood Company had joined with Northwest Door in the purchase of that timber for Mr. Ellison* and I then re-drafted the instrument to include Vancouver Plywood as a part of the parties of the first part who were going to advance the necessary funds needed by him to purchase this timber and log it. That was my purpose." (R.56). (Emphasis supplied.)

There is certainly nothing in the record from which it can reasonably be determined that the Court either should or intended to brand every witness before him as a prevaricator. In view of the Court's statement in its oral opinion regarding the contract, (R.124, 125), it is apparent that the Court did not disbelieve the testimony, but simply concluded that it was of no legal effect to "vary the terms of the instrument," and hence, like the Tax Court in the first *Landa* case, ascribed no

weight to it. This was error. The testimony of the various witnesses should have been considered. In fact, consistent as it is with the function of the instrument and the circumstances of the case, and being uncontradicted and unimpeached, it is conclusive. It establishes the fact that Ellison was the beneficial owner of the timber and logs herein. *Landa v. Commissioner*, 206 F.2d 431 (D.C. Cir. 1953); 211 F.2d 46 (D.C. Cir. 1954).

II

The evidence compels the conclusion of law that Ellison was the equitable owner of the contract right to cut the timber and had harvested and sold it in the course of his business.

We submit that it has been established by the undisputed facts that Ellison was the equitable, beneficial owner of the contract right to cut granted by the Forest Service contract, Exhibit 2, and that this court may so find. *McGah v. Commissioner*, 210 F.2d 769 (9th Cir. 1954), Rule 52 (a), Federal Rules of Civil Procedure.

Nor is it an original idea that in tax matters form will not prevail over substance and the names given by parties to the transactions and documents entered

into by them, while of some value, will not be permitted to control the true nature of the operative facts.

As stated in *Hamme v. Commissioner*, 209 F.2d 29, 32 (4th Cir. 1953):

> "It is well established, however, that the name used by the parties in describing a contract and payments thereunder, do not necessarily determine the tax consequences of their acts. * * * In the field of taxation we must be controlled by the substance and reality of a transaction rather than by the formal attributes of written documents. * * *"

Moreover, this rule is not a one-way street which operates only in favor of the taxing authorities. "The taxpayer as well as the Commissioner of Internal Revenue is entitled to the benefit of this rule." *Landa v. Commissioner*, 206 F.2d 431, 432 (D.C. Cir. 1953); *Landa v. Commissioner*, 211 F.2d 46, 50 (D.C. Cir. 1954); See also *Edward Peterson Company v. O'Malley*, 216 F.2d 98 (8th Cir. 1954).

A recent decision in this Circuit, *Hatch's Estate v. Commissioner*, 198 F.2d 26 (9th Cir. 1952), illustrates the operation of the rule, and particularly the fact that documents must be viewed in their context as an integral part of a whole, rather than abstracted entirely from their background (198 F.2d at p. 29). This Court there stated the applicable rule as follows:

> " * * * in dealing with a tax matter we must be guided by the substance and effect of what was done. *United States v. Phellis*, 1921, 257 U.S. 156, 168, 42 S. Ct. 63, 66 L. Ed. 180. This is not to say that we are to disregard the language used in a contract which may be involved, or the methods used to effect the transaction. But rather, *we must consider the form and steps used in their relation to the intended and accomplished entire transaction. Halliburton v. C.I.R.*, 1935, 9 Cir., 78 F2d 265. As the old homely saying has it, 'The tail must not wag the dog.' " (Emphasis supplied).

In that case, too, the rule was applied in favor of the taxpayer, and the Tax Court's finding of fact was reversed as "clearly erroneous."

A decision of the Supreme Court is worthy of consideration because of elements of similarity to the present situation. In *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252, 60 S. Ct. 209, 210 (1939), the taxpayer was attempting to claim depreciation on a store, legal title to which it had "purported to convey." The courts below found that the conveyance was for security purposes, and held that the taxpayer "owned" the building for purposes of claiming depreciation. The Supreme Court affirmed, stating:

> "General recognition has been given the 'established doctrine that a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money.' In the

> field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding."

It perhaps need hardly be added that the courts of Washington recognize the doctrine that a deed absolute on its face may be in reality a mortgage. *Beadle v. Barta*, 13 Wash. 2d 67, 123 Pac.2d 761 (1942). It is also the law of Washington that in determining the character of the transaction, it is the intention of the parties that controls, and that all surrounding circumstances may properly be inquired into to get at the real nature of the instrument. *Pittwood v. Spokane Savings & Loan Society*, *supra*.

This is, of course, not precisely the same situation that we are faced with in the instant case, because here Ellison never had legal title to the timber or the logs. In that respect, this case was more like a conditional sale or a trust receipt than a mortgage. But it is not necessary to pin down the nature of the instrument, so long as it is established—as it was in this case—that the sole function of the document was to provide security. That being established, it follows that Ellison was the beneficial owner. Again, compare the case of *L. D. Wilson*, 26 T.C. No. 56 (1956), wherein the partnership never owned legal title to the timber and the logs, but

the court nevertheless held it to be the "owner" for the purposes of the second subsection of Section 117 (k).

Taken all together, therefore, the evidence establishes the fact that it was the intent of the parties, in entering into the contract designated as Exhibit 3, that it would not define the status and relationship of Ellison and Northwest with respect to beneficial ownership of the timber. It was a security device, designed to insure that Ellison delivered the logs to no one but Northwest so that the latter would obtain the supply of logs it needed, and would be repaid its advances from the proceeds thereof. Northwest considered this a log purchase, rather than a service contract, and handled it on its books as such. The language of the document, as described by Eisenhower's testimony, was drawn with security in mind, and nothing more.

III

The benefits of Sec. 117 (k), I.R.C. 1939, are available to Ellison, as equitable owner of the contract right to cut the timber, even though naked legal title was held by another.

In considering this case, it is to be noted that a somewhat similar case involving Section 117 (k) (1), I.R.C. 1939, is, *Helga Carlen*, 20 T.C. 573 (1953); aff'd. *Carlen v. Commissioner*, 220 F.2d 338 (9th Cir. 1955).

The *Carlen* case holds that the taxpayers, although having a contract right to cut the timber, did not have a proprietary interest or the right to sell the logs on their own account, and hence did not qualify under the statute.

In the instant case, the contract between Northwest and the Forest Service, (Ex.2, p.4, Clause 6) provides:

"Section 6. * * * The title to all timber included in this agreement shall remain in the United States until it has been paid for, felled and scaled, measured, or counted."

The evidence establishes an assignment of the Forest Service contract from Northwest to Ellison and, that by agreement of the parties, Ellison was the equitable owner of and had a contract right to cut the timber, the evidence further establishes that Ellison was treated as the owner of the contract and the equitable owner of the timber by Northwest and the Forest Service, even though no written assignment of the contract between Northwest and the Forest Service appeared on the latter's record.

The remaining issue is whether the cutting of the timber by Ellison was, within the meaning of the statute, for sale, or for use in his trade or business. This

issue is further narrowed by the fact that Ellison's business was, as the Court found (R.25), the cutting and marketing of timber, and hence the use made by Ellison of the cut timber in his trade or business was a sale thereof. If there were no evidence in this case other than Exhibits 2, and 3, the similarity between this and the *Carlen* case would perhaps be sufficient to justify the court in following *Carlen*. The misapprehension of the court was that the *Carlen* case was indistinguishable from this one. This was the position taken by the district director at the start of the case (R.35), the conclusion announced by the court in his oral opinion from the bench (R.123), and was embodied in his Conclusions of Law (R.25). This statement is comprehensible only if the documents accurately and completely defined and stated the relationship between Ellison, Northwest and the Forest Service for all purposes. All of the testimony and other documentary evidence in this case refute that conclusion.

The basic distinction is that in the *Carlen* case the contract reserving title accurately defined the status of the parties. The Tax Court stated (20 T.C. at p. 578) that the taxpayers therein argued that the reservation of title was for security only, but there does not appear to have been any evidence whatsoever that this was the case, other than the method of payment based upon

market price. In the instant case, there was uncontradicted testimony, both by the President of Northwest and by its Secretary and Counsel (Eisenhower), who drafted the contract, that its purpose was solely for security. This in itself is sufficient to distinguish the cases, and all of the evidence corroborates this testimony.

In this case, Ellison dealt directly with the Forest Service in such substantive matters as relocating roads and exchanging timber. There was no such evidence in *Carlen*. Ellison's business included marketing logs. Carlen's business was stipulated to be "logging timber." The intent of the parties was never set forth in *Carlen;* here, it was established not only by direct testimony, but by the fact that Northwest treated the logs as Ellison's on its books, permitted him to deal directly with the Forest Service, and did not claim capital gains treatment, that Northwest as well as Ellison intended Ellison to be the real party in interest.

In the instant case there was evidence that Northwest treated logs which Ellison had purchased in his own name in the same manner as the logs delivered under this contract; there was no such circumstance in *Carlen*. In *Carlen*, the logger was required by his contract to operate at least forty-eight hours per week; here Ellison had complete discretion. The scaler was to be

either an agency set forth in the contract or one that the parties could agree upon, whereas in *Carlen*, the scaler was to be selected by the mill.

In the instant case, the timber was purchased by Northwest at the instance of Ellison, with the intention that he would log it, whereas in the *Carlen* case, the timber had been purchased before the logging partnership had even been formed.

Assuming, therefore, that Ellison had the beneficial interest in this timber, the question remains whether he is entitled to claim capital gains treatment under Sec. 117 (k) (1). Both the decisions of the Tax Court and of this Court in *Carlen* seem to be implicit with the assumption that such is the case. Thus, the Tax Court found it necessary expressly to reject the contention of the taxpayer therein that title was reserved for security.

Ellison was not the owner of the timber in the sense of strict legal title, although the case of *L. D. Wilson*, 26 T.C. No. 56 (1956), previously cited, supports the proposition that he was the "owner" for purposes of Sec. 117 (k) (2), which presumably is to be interpreted *in pari materia* with Sec. 117 (k) (1). In any event, he did have a contract right to cut the timber. Whether or not he cut it for sale or for use in his

trade or business, depends, in the language of the *Carlen* decision (220 F.2d 338, at p. 340, quoting with approval from 20 T.C. at p. 578) upon whether Ellison had a "proprietary interest which he can dispose of by sale."

If by "proprietary interest" were meant mere naked legal title, the Court could very easily have said so. In the instant case, the evidence supports a finding that Ellison had every proprietary interest except naked legal title, which was retained in the Forest Service or Northwest for the purposes of security. Within the meaning of the statute, as interpreted by the *Carlen* decisions, it is appellant's contention that he did have a proprietary interest, and that he was entitled to the benefit of his election to take capital gains treatment on the transaction. The court below relied entirely on the one document, Exhibit 3, which document was designed for a specific purpose, to determine all of the rights and duties of the parties thereto for all purposes.

In view of Ellison's Request for Admission, pars. 8 through 11 inclusive (R.8,9), and the tax collector's Reply to Request for Admissions, par. 6 (R.11), and par. 14 of the Findings of Fact (R.25) there is no dispute that Ellison held his right to cut the timber for the required period, and that he did cut it for sale in his

business, which was producing, transporting, and marketing logs.

It is our contention, based upon the uncontradicted, unambiguous evidence of disinterested and unimpeached witnesses, consistent with the circumstances of the case and the purpose of the document, that Ellison was at all times the equitable owner of the timber contained on the Green Forks Tract and that he owned the contract right to cut, and did cut that timber for use in his trade or business. The judgment of the District Court should be reversed, or in the alternative, the case should be remanded for new trial with instructions that the oral evidence be considered and appropriately weighed.

SUMMARY

The judgment should be reversed for error in failing to consider relevant evidence, because the findings and conclusions upon which the judgment appealed from are based can be sustained only if it can be affirmatively said that the rights of Ellison are to be determined solely by the contract.

Respectfully submitted,

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APPENDIX

Section 117 (j) of the Internal Revenue Code states in part:

"(j) **Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.**

"(1) **Definition of Property Used in the Trade Business**—For the purposes of this subsection, the term 'property used in the trade or business' * * * includes timber with respect to which subsection (k) (1) or (2) is applicable."

Section 117 (k) (1) provides:

"(k) **Gain or Loss upon the cutting of timber**—

"(1) If the taxpayer so elects upon his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than six months prior to the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. In case such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the adjusted basis for depletion of such timber in the hands of the taxpayer and the fair market value of such timber. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election

under this paragraph such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding upon the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Commissioner, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this paragraph except with the consent of the Commissioner."

Section 117 (k) (2) provides:

"(2) In the case of the disposal of timber (held for more than six months prior to such disposal) by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber, the difference between the amount received for such timber and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber."